



*Harbor Views*

SEPTEMBER 2006

### **Thoughts on the Economy**

The growth rate of the U.S. economy is slowing from 5.6% in the first quarter to 2.6% in the second. The effects of 17 consecutive .25% interest rate increases by the Federal Reserve as well as high energy and other commodity prices have conspired to slow growth in output to what the Bulls would call a soft-landing scenario and what the Bears would term a recession. We believe the odds and historical precedent would favor, at best, a mid-cycle slowdown and very possibly a mild recession. (Recessions are defined as two consecutive quarters of negative GDP growth.)

The residential housing market is slowing rapidly, reducing consumer spending by preventing equity extraction which has provided an over 1% boost in spending in each of the last three years. Inventories of unsold homes are at a 7.5 month supply at current sales rates, an eleven year high. Prices declined year over year for the first time since 1995 in the month of August as the median house price dropped by 1.7%. In the Northeast the decline was more pronounced at 3.9%. We expect further declines this year and early next year as well. We suggest buyers exercise patience and sellers be realistic on pricing.

The Federal Reserve has finished raising rates and will now focus on the extent of the slowdown with an eye toward when to begin lowering rates. Our guess would be early in 2007. The Fed's record of going too far with tightening cycles and waiting too long to reverse course and begin easing would suggest a hard landing is the highest probability outcome for our economy.

The good news is this potential slowing in U.S. growth comes at a time when worldwide growth is accelerating which could help

reduce the length and depth of the U.S. slowdown. Inflation readings are rolling over on the core rate and the cycle peak may have been reached in June with a year over year core consumer inflation rate of 2.8%. We expect core prices to head back toward 2% later this year and in 2007. The U.S. dollar should again begin a moderate decrease in value against the currencies of our major trading partners benefiting U.S. exports which are already doing well.

Energy prices are dropping quickly as the expectations for economic growth are lowered. The hurricane season is nearly over without any large supply disruptions. The large Chevron find in the gulf (the largest since the North Slope discovery in Alaska) has helped reduce the speculative premium in oil, lowering the price to the \$60/bbl area.

We continue to believe energy prices will remain high relative to the levels of just a few years ago. A range of \$55-75/bbl on oil would not surprise us.

Employment gains remain a catalyst for consumer spending with an average of 140,000 non-farm jobs added each month year-to-date. Labor productivity growth of 2-3% continues to be a differentiating factor for the U.S. economy.

Harbor expects GDP growth in 2006 to weaken in the second half of the year and bring the rate for all of 2006 to 3-3.5%. We expect inflation to slow to near 2% and for corporate earnings to grow by better than 10% in 2006.

### **Our view of the Financial Markets**

The third quarter has been strong for U.S. equity markets with the large capitalization blue chips leading the advance. We continue to believe the multiple contraction of the last

six years has restored fundamental value to large cap stocks and believe our prediction of 7-10% total returns for the year are achievable. Earnings per share growth should exceed 10% this year, marking another record year for corporate profitability.

We expect a moderating U.S. dollar to boost exports as well as increase translated earnings for multinationals which are heavily represented in Harbor client portfolios. If the Fed begins an easing cycle in 2007 the outlook for financial assets would improve as valuations generally expand during an easing cycle. Even if corporate earnings growth slows, which we expect, rising valuation levels should lift stock prices in 2007.

U.S. corporations are raising dividends rapidly as well as buying back shares in record amounts. This use of record cash levels to benefit shareholders continues to encourage us. We would much prefer CEOs return cash to shareholders than to invest in ventures with low incremental returns on equity.

Private equity firms, LBO funds and venture capital firms are rolling in record levels of cash which is being deployed in large degree in the reduction of public equity outstanding. The money is being invested in ever larger deals which will eventually reduce the returns achieved by these funds. Hedge funds are estimated to hold \$1.2 trillion, some of which is being used to retire outstanding shares. The wave may have crested in terms of the flows into hedge funds as investors become aware of just how risky and short-term oriented these vehicles can be. The recent revelation that Amaranth lost 65% of its \$9.0 billion in capital in one week has focused the spotlight on risk management, a concept most investors have trouble understanding. Our definition of investment risk is "the possibility of

permanent loss of capital". The street likes to define risk in terms of the volatility of returns which never made much sense to Harbor.

Fixed income returns should improve as the Fed is on hold and prepares to ease. Long-term rates have fallen by 70 basis points since the Fed last raised rates in June. Harbor clients continue to enjoy healthy returns on their Fixed Income investments as opportunistic investments in the Auto Finance sector perform strongly.

### **Pension Protection Act of 2006**

The August 2006 passage of the above named bill in Congress included an interesting tax planning opportunity for clients over 70.5 years of age. The bill allows for an annual distribution of up to \$100,000 to be taken from an IRA and counted for purposes of the required minimum distribution but not included in taxable income if the money is gifted to a qualifying charity. There is no charitable deduction allowed however on this type of gift. If you had in mind a charitable contribution and have a sizeable IRA account which requires that you take the RMD this year but you do not need the money to live on, this could be a very interesting tactic.

### **529 Plans Permanently Tax-Free!**

Last month President Bush signed into law a tax bill making permanent the Federal tax-free status of 529 Plans.

*HARBOR ADVISORY*

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Nod to the ubiquitous disclaimer:

While we are not infrequently, and always quite accurately, accused of being of strong opinion...we want to let the reader know we've been wrong before...will be again and please don't hold it against us. The forward looking parts of the letter are the best educated efforts of fallible humans here at Harbor.